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Q. Okay. And how would an economist go about apportioning harm between the effect of the holding company notes and the effect of a hypothetical capital structure decision, absent the holding company notes?
A. Well, I think what you do is, you take into consideration the difference in the probabilities of Marvel experiencing financial distress.
Q. Okay. This goes back to your damages methodology of forecasting the probability of financial distress with and without the holding company notes?
A. Correct.
Q. Okay. Would you please take a look at paragraph 10 of Holthausen Exhibit 1?
A. Okay.
Q. All right. Do you see that paragraph 10, you say that Mr. Baliban incorrectly applied the Andrade and Kaplan estimate of financial distress costs of 10 to 20 percent because such an estimate should be applied to the distressed company one year prior to the onset of financial distress?

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MR. ALLINGHAM: I apologize. Were you reading, or is that a summary?
MR. GOLDWATER: It's a summary.
MR. ALLINGHAM: Sorry.
A. Yes, I see that.
Q. And do you see that you support that opinion with a reference in footnote 3 of your report to page 1463 of the Andrade and Kaplan study?
A. Correct.
Q. Okay. Let me hand you the Andrade and Kaplan study. Can I have this marked as Holthausen Exhibit 2?
(Andrade and Kaplan study is marked as Holthausen Exhibit 2 for Identification.)
Q. Okay. I show you what's been marked as Holthausen Exhibit 2. Does that look like a copy of the Andrade and Kaplan study that we've been talking about?
A. Yes.
Q. Okay. And would you please take a look at the page that you reference in footnote 3 of your report, page 1463?
A. Okay.

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Q. Okay. Now, the text on that page is discussing an estimate of financial distress costs based upon changes and operating performance that's reflected in a chart on page 1464. Do you see that?
A. Correct.
Q. My question is: Why do you identify the particular estimate on page 1463 as the applicable measurement of financial distress costs?
A. Well, what I'm referring to here is the 10 to 20 percent estimate that came out of Mr. Baliban's report. And I believe this is where that 10 to 20 percent estimate comes from out of his report.
Q. Did you see a citation to this particular measure or -- I'm sorry -- this particular estimate in Mr. Baliban's report?
A. I don't remember that off the top of my head, whether there was a particular reference to this.
Q. Okay. Within the Andrade and Kaplan study there are a number of estimates of financial distress costs. Isn't that true?
A. Yes.

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Q. Okay. And have you done anything to determine whether the estimates on page 1463 are more applicable to the facts of this lawsuit than any of the other estimates of financial distress costs within the Andrade and Kaplan study?
MR. ALLINGHAM: Would you read that back, please?
(Counsel requests the reading of the following testimony:
"QUESTION: And have you done anything to determine whether the estimates on page 1463 are more applicable to the facts of this lawsuit than any of the other estimates of financial distress costs within the Andrade and Kaplan study?")
A. Could you repeat that one more time?
Q. I'll just say it.
A. Okay.
Q. Have you done anything to determine whether the particular estimate based on changes in operating performance referenced on page 1463 is more applicable to the facts of this lawsuit than any of the other estimates which are also contained within the Andrade and Kaplan study?

A. What I've done is, I've looked at a series of estimates of financial distress costs that come out of their paper. I haven't just looked at one. I've looked at alternatives as well.

Q. And as you say, I think, somewhere in your report, that you have to consider all of the evidence in that study. Isn't that right?

A. That's correct.

Q. Okay. It's not appropriate to single out one measure. Isn't that right?

A. I think that's right.

Q. Okay. Towards the bottom of page 5 of Holthausen Exhibit 1, you note that "Marvel announced an attempt to restructure its debt on October 8, 19 -- October 8, 1996," and you say that that is the "appropriate date of distress consistent with Andrade and Kaplan."

Do you see that?

A. Yes.

Q. Okay. And what do you mean by the "date of distress"?

A. Well, Andrade and Kaplan measure financial distress costs by looking from the

fiscal year prior to the onset of financial distress. And they define in their study the onset of financial distress as either of those three things that I mention: defaulting on a debt payment, trying to restructure the debt, or EBITDA falls below interest expense.

Q. So they define the onset as the fiscal year prior to the financial distress event or signal?

A. No. They define the onset as those three things, and then they measure it from the fiscal year prior to the onset through post-resolution, for example.

Q. Okay. And according to the measurement in the Andrade and Kaplan study, is the impact of financial distress felt on a particular date or over a period of time?

A. They don't measure that because they look over long windows, so they don't say it occurred on this date or that date. They look over a period of time, and they look at various windows.

Q. Yes. They measure the impact over various intervals of time, depending on which

particular methodology they're applying?

A. Correct.

Q. Okay, okay. If you look at paragraph 10 on page 6 of your report -- it's the first complete sentence on page 6. It starts, "Under the methodology of the study," and then the sentence goes on. Do you see that?

A. Uh-huh.

Q. What are you referring to when you say "the methodology of the study"?

A. Well, when Andrade and Kaplan talked primarily about their 10 to 20 percent estimate, it comes from this table 6 measuring from -- I guess it's in panel B -- from year minus one to post-resolution. And so these numbers of financial distress that you see here in that panel B are measured from the fiscal year prior to the onset of financial distress. So these percentage estimates that they're getting are based upon what the value of the firms were at that point in time. So if you want to use these 10 to 20 percent estimates which come from this table, then I think you have to apply it -- or you have to apply it to the like period for Marvel.

Q. So you're assuming that Mr. Baliban is also using table 6?

A. Yes --

Q. Okay.

A. -- because I think that's where the 10 to 20 percent in Andrade and Kaplan primarily comes from.

Q. And I think we've already discussed: The relevant time interval for the measurement of financial distress cost depends on the particular methodology that's being applied?

A. Say that again.

Q. Within the study, the relevant time interval for the measurement of financial distress costs, it depends on the particular methodology within Andrade and Kaplan that they're using?

A. Well, they measure it over different time windows.

Q. Okay. So we would have to know what Mr. Baliban was looking to for his estimate?

A. Correct. But I think when he talks about 10 to 20 percent, this is primarily where it comes from.

Q. And what do you base that on?

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A. The Andrade and Kaplan study.

Q. No. What do you base your statement that Mr. Baliban is primarily using --

A. Well, this is where I think Andrade and Kaplan basically get their 10 to 20 percent from, and he gets it from Andrade and Kaplan.

Q. Okay. Let me just finish the question.

A. I'm sorry. Right.

Q. Where do you base your statement that that's where Mr. Baliban gets the 10 to 20 percent from?

A. Perhaps he got it from someplace else, but I believe Andrade and Kaplan got the 10 to 20 percent from this table.

Q. Okay. Would you please take a look at paragraph 12 of Holthausen Exhibit 1?

A. Yes.

Q. In the second sentence of paragraph 12, you say that "The Andrade and Kaplan study provides another potential measure of the expected cost to Marvel associated with the indenture covenants," and the sentence goes on.

A. Uh-huh.

Q. What do you mean by a "potential

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measure"?

A. I could have just used another measure.

Q. Are all the methodologies used to estimate the cost of financial distress in the Andrade and Kaplan study potential measures?

A. Well, they're potential measures measured at various points of time. Whether they're all appropriate or not depends on what you're trying to do.

Q. Okay. And did you do anything to determine, out of the universe of measures within the Andrade and Kaplan study, which was the most appropriate measure for use in this lawsuit?

A. Again, what I -- since I want to measure the expected cost, I want to measure the cost from prior to the onset of financial distress to post-resolution, and that's based upon wanting to know sort of what the ex-ante effects were going to be.

Q. So did you do an analysis of the difference in enterprise value of Marvel prior to the onset of financial distress and post-resolution?

A. You'll have to say that again.

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Q. My question to you is whether you had done any analysis to determine which, out of the several measures or several estimates of financial distress in Andrade and Kaplan, which was the most applicable to the facts of this case. And you said, well, I was looking at a measure that looked at the difference before a financial distress and up until post-resolution of distress.

A. That has to do with my theory of economic damage -- right? -- because that's the period where we want to look at it from sort of this ex-ante view, which goes from before to after.

Q. So what did you do specifically? I'm not clear on what you did.

A. Well, I'm looking at situations where -- so, for example, in panel B I want to measure the financial distress from the year prior to the onset of financial distress to post-resolution.

Q. Panel B of what?

A. Excuse me? I didn't understand.

Q. You mentioned a panel B. I'm not sure --

A. I'm sorry. Panel B of table 6.

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Q. So you actually did an analysis according to the time interval in table 6 of the Andrade and Kaplan study?

A. Right, and some of the other tables, too. With my damage analysis --

Q. I'm sorry to interrupt you. And you said some of the others, too. Which of the others did you do that for?

A. Well, the other ones that I refer to in my report.

Q. Okay, just those. I guess I'm not -- can you show me which and where in your report you refer to some others?

A. Well, for example, I talk in page 7 about table 5, and in paragraph 13 I talk about panel B of table 9, so I try to be pretty explicit about where I'm pulling the data from.

Q. So you did do analyses for a few of the methodologies within the Andrade and Kaplan study. Did you do anything to determine which was the most appropriate or most applicable of the Andrade and Kaplan estimates?

A. Well, I selected from -- there were some that I selected based upon my damage theory.

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Right? And those are the ones that I talk about in my report that I think are most appropriate.

Q. Okay.

A. And then I talk about, for example, you know, the 10 to 20 percent estimate, and I also talk about the 0 percent estimates that Andrade and Kaplan get in their study.

Q. Okay. So to the extent you did any selecting, it was of methodologies that you viewed as able to be harmonized with your theory of damages?

A. Correct.

Q. Can I just ask you in that same sentence that we started off on, that second sentence of paragraph 12 where you're saying that the Andrade and Kaplan study "provides another potential measure of the expected cost to Marvel"? Why do you say that the Andrade and Kaplan study "provides a potential measure of expected costs"? I'm focusing now on "expected."

A. I can see that the word "expected" there could be misconstrued because this application of Andrade and Kaplan still would assume that -- would be based upon the certainty assumption and

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the sole causation assumption. So I'm using it in a different -- different term -- different way than I had used the word "expected" before, and I could see it could be misconstrued.

Q. Is it your belief that the Andrade and Kaplan study is trying to measure expectations as to cost of distress rather than the actual cost of distress?

A. No. They're trying to measure actual cost of distress.

Q. Okay. The next sentence in paragraph 12, you refer to a different time interval. You note that in another estimate within the Andrade and Kaplan study, they measure from two months prior to a highly leveraged transaction to a point in time immediately after the resolution of distress. Do you see that?

A. Right.

Q. Just the next sentence?

A. Yes.

Q. Did you make any effort to apply that measurement to Marvel?

A. Yes. I talk about what the financial distress costs would be if you apply that measure

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to Marvel.

Q. Where is the --

A. Well, I apply what the effect of the holding company notes would be to Marvel under the assumption that the holding company notes force Marvel to become a highly levered firm.

Q. Where is that?

A. Where is what?

Q. What you just said. You say that you apply it. Where is it that you apply it?

A. Well, all I do is, I talk about. I apply it in the sense of when they look at this, they report from the time prior to the highly levered transaction to post-resolution of distress that the capital earns positive returns. Point estimates and none of the returns are significantly different from zero. So applying that would indicate that, if you take the view that Mr. Baliban does, that the indenture covenants caused Marvel to become a highly levered firm, this would suggest -- this estimate here suggests that the cost would be zero.

Q. Did you look at the actual difference in enterprise value if you applied that to the

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historical facts?

A. I don't understand the question.

Q. Did you try to determine the difference in enterprise value from Marvel two months prior to a note issuance, a parent company note issuance to post-bankruptcy?

A. For what purpose? The point here is that -- what they're saying is that the returns are zero to the capital earned. Okay? Their point estimates are positive, and they're insignificantly different from zero in a statistical test.

Q. Yeah. And I'm just asking you if you did that -- if you used that time interval and applied the time interval to Marvel in a way -- I understand what you're talking about with the study. I'm just asking you whether you used that time interval and applied it to Marvel.

A. Well, what I conclude from this is, here's another measure out of Andrade and Kaplan, and this measure out of Andrade and Kaplan would give you zero economic harm.

Q. I understand.

A. Okay.

Kaplan, their 10 to 20 percent cost of financial distress, they talk about it over and over again as it being an upper bound because it's mixing -- even in that sample, which they tried not to get any economic distress in, it already has economic distress. We don't want to measure economic distress. We want to measure financial distress. We want to measure something that was caused by the capital structure under the assumption that the indenture covenant notes caused the capital structure to be highly levered.

Q. What do Andrade and Kaplan find for companies that suffer from both economic and financial distress?

A. You mean the shock sample?

Q. Correct.

A. Well, we can look it up, but it's not relevant because what they're saying is that that mixes in the economic distress, and we're trying to measure the financial distress.

Q. If Marvel, in fact, suffered from economic distress, how is that not a relevant sample?

A. Because the economic distress that

Marvel suffered had nothing to do with the indenture company notes. The reason that it suffered economic distress was because the comic book business turned down, the sticker business turned down, they all turned down. And we're trying to measure financial distress costs here, not economic distress.

Q. Okay.

MR. GOLDWATER: Do you want to break for lunch now?

MR. ALLINGHAM: Sure.

THE VIDEOGRAPHER: Standby. The time now is 12:54 p.m., and we're going off the record.

(There is a luncheon recess taken.)

AFTERNOON SESSION

THE VIDEOGRAPHER: The time now is 1:37 p.m., and we're back on the record.

BY MR. GOLDWATER:

Q. Mr. Holthausen, would you please take a look at paragraph 16 of Holthausen Exhibit 1? Do you see in the very first sentence of paragraph 16, you state that "The probability of financial distress for any scenario is derived from an option model"?

A. Correct.

Q. Okay. What definition of "financial distress" are you now using in paragraph 16?

A. The definition that the model uses is whether the value of the assets will fall below the value of the debt.

Q. When you refer to "the model," what is it you're talking about?

A. This option model that's in the Hillegeist, Keating, Cram, and Lundsted paper.

Q. That's the paper referenced in footnote 9 of your report, Holthausen-1?

A. Correct.

Q. And in that report they refer to what

you just described as the value of the assets falling below the value of the debt as bankruptcy. Is that correct?

A. They use that to estimate the probability of financial distress, right. So, in other words, if the assets are -- the value of the assets is way above the value of the debt, then there will be no financial distress at the time that the debt has to be repaid.

Q. I'm just asking you a question. When -- within that study that you reference in footnote 9 of your report, how do they define "bankruptcy"? Is it the same -- is it what you just said, the value of the assets falling below the value of the debt at a given point in time?

A. Correct.

Q. And are you using their definition of "bankruptcy" as a proxy for financial distress in your report?

A. Well, what comes out of the model is actually a probability of financial distress, so I'm using the probability that comes out of the model. And the probability is estimating: What is the likelihood that the value of the assets

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will fall below the value of the debt?

Q. Will I see the words "financial distress" in the article assessing the probability of bankruptcy?

A. No. I think they talk about it as bankruptcy.

Q. Okay.

A. They may talk about financial distress, but I don't remember.

Q. Okay. And when you talk about financial distress in paragraph 16 and, I assume, the following analyses, you are talking about bankruptcy as defined in the assessing-the-probability-of-bankruptcy study?

MR. ALLINGHAM: Object to the form of the question.

Q. I can rephrase to meet the objection. When you refer to "financial distress" in paragraph 16 and thereafter, what are you referring to?

MR. ALLINGHAM: I still object to the form of the question. Sorry.

Q. Are you referring to the -- when you refer to "financial distress," are you referring

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to how the authors of the assessing-the-probability-of-bankruptcy article define "bankruptcy"?

A. I'm referring to the probability that the value of the assets will fall below the value of the debt.

Q. Okay. So that's a different definition of "financial distress" than, for example, the authors of the Andrade and Kaplan study use?

A. They're somewhat different, yes.

Q. And why are you relying on an article that addresses probabilities of bankruptcy?

A. Because the likelihood of financial distress is going to be a function of what those values of the assets are relative to the value of the debt. And so what we're doing here is, we're using this as an estimate of that probability.

Q. When you say that "The likelihood of distress is a function of assets versus debt," in what -- in what way -- what is the function?

A. What is the functional form?

Q. I'm not -- how is the likelihood of distress a function of the value of assets versus the value of debts?

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A. Well, if the value of the assets far exceeds the value of the debt, then it's unlikely that the firm is experiencing any financial distress. When the value of those assets falls well below the value of the debt, then it's highly likely the firm is in a distressed situation, and at that point the equity holders may just choose to let the debt holders have the firm.

Q. So this is a model, this assessing-the-probability-of-bankruptcy model, where all assets are equivalent regardless of their liquidity?

A. The model makes -- yeah, the model makes that assumption, yes.

Q. And all the liabilities are equivalent regardless of the maturity or time when they're due in reality?

A. Well, not the way we estimate the model.

Q. Is there actually a calculation you could perform that could translate the financial -- the likelihood of financial distress as used by Andrade and Kaplan into the probability of bankruptcy as used in the assessing-the-probability-of-bankruptcy study?

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A. Say again.

Q. Is there actually a calculation one could do to translate the probability of financial distress that you extract from Andrade and Kaplan and conform it to assessing the probability of bankruptcy as used in that study?

A. No. I think they're very related to one another. And all we're doing here is, we're assessing the difference between two probabilities.

Q. Okay. A company can be in financial distress without being in bankruptcy. Isn't that right?

A. It's conceivable that a company could be in financial -- in some kind of financial distress without actually having gone into bankruptcy.

Q. And a company can be in bankruptcy without being in financial distress. Isn't that right?

A. Both of those things can happen. That's correct.

Q. Are you assuming that the injury that Marvel would sustain from the probability of a bankruptcy is the injuries that would flow from

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filing a bankruptcy petition? Let me just ask you in general.

What injuries is it that you think Marvel would sustain from filing a bankruptcy petition?

A. I'm looking at what the injury is associated with the financial distress cost as estimated by Andrade and Kaplan. And I'm using as an approximation for the probability of financial distress the bankruptcy probability. And more particularly, what I'm doing is, I'm using the change in that probability of bankruptcy as a proxy for the change in the probability of financial distress.

Q. I have a very much smaller question, which is: What injuries would Marvel sustain from filing a bankruptcy petition?

A. I did not analyze that.

Q. What injuries would Marvel sustain from incurring a period of financial distress?

A. The estimates of the injuries from financial distress come from the Andrade and Kaplan paper.

Q. Right. And qualitatively, do you happen to know what those injuries are?

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A. Well, they can be a lot of different things. They can be customers deciding, you know, that they no longer want to enter into contracts with them. It may be that they might not be able to license products because people don't know if they're going to be around.

Q. And do you know the period of time in which Marvel would sustain injuries from financial distress?

A. The period of time? I don't understand your question.

Q. Over what period of time Marvel would sustain injury from financial distress?

A. It would depend upon how long they were in financial distress, I presume.

Q. So you don't know how long they would sustain injury pre-bankruptcy petition if they were in financial distress versus post-bankruptcy petition, I take it?

A. No.

Q. Okay. Do you believe that an increase in the probability of bankruptcy is the only injury that Marvel could sustain from financial distress?

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A. I don't really understand the question. What I'm doing to estimate the cost of financial distress is the estimates from Andrade and Kaplan in conjunction with the change in the probability that they're going to experience financial distress.

Q. Have you tried to measure the extent of an injury from financial distress other than the incremental probability of bankruptcy as of February 15, 1994?

A. Well, it's the incremental probability of bankruptcy in conjunction with the estimates from Andrade and Kaplan.

Q. What is in conjunction with the estimates from Andrade and Kaplan adding? I'm missing that. Have you tried to measure the extent of any -- obviously you tried to measure the extent of injury from an incremental probability of bankruptcy as of February 15, 1994. Do we agree on that?

A. Well, the injury isn't just the change in the probability. You have to multiply the change in the probability times the cost.

Q. Okay.

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A. And that's where the Andrade and Kaplan study comes in. That's where the cost comes in.

Q. And have you tried to measure the extent of any injury from financial distress other than that incremental change in probabilities?

MR. ALLINGHAM: I object to the form of the question.

A. Again, it's in conjunction with the Andrade and Kaplan study. It's not just the change in the probability.

Q. Okay. Multiplied by whatever figure you derived from Andrade and Kaplan?

A. Correct.

Q. And have you tried to do -- measure the extent of an injury other than that multiplication calculation which is, you know, the one you just told me?

A. Well, the only other estimate I have of injury in the paper has to do with the price response to the October 17 announcement. But, again, that's an ex-post measure of damage, not an ex-ante measure of damage.

Q. Okay. And other than what you've just told me, is there anything else you've tried to

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measure?

A. No.

Q. By the way, does the -- when assessing the probability of bankruptcy, I assume that's a probability of bankruptcy on a given date as opposed to a period of time?

A. It's the -- the way it's measured in this paper, it's: What's the probability that the firm would have experienced bankruptcy by the due date of, in my case, the Marvel III notes?

Q. Okay. And how do you go about calculating the probability of bankruptcy?

A. Well, you use this option model. And if we turn to one of the exhibits, we can walk through it, if you want. Well, I guess we can start with Exhibit 4.

Q. Okay. What are the inputs to your methodology for assessing the probability of bankruptcy?

A. The inputs vary a little bit, so we have to talk about a particular scenario, so can we talk about without the Marvel III notes?

Q. Okay.

A. Well, the inputs then are the face value

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of the zero-coupon-equivalent liabilities, which basically is saying, "Let's take the liabilities prior to the time of the Marvel III notes," and let's assume that they were all zero coupon liabilities, so the interest just accrued on them. We then take the years to maturity on the Marvel III notes, which is four years. We estimate the equity volatility of Marvel, which is around 48.5 percent. We estimate the risk-free rate over the four years of the Marvel III notes. And we calculate the market value of the equity of Marvel as of February 15, '94, when the Marvel III notes were issued.

Q. Okay. I see in your note to equity volatility, you state that you derive your equity figure "from the standard deviation of daily Marvel stock returns over the year prior to February 15, 1994"?

A. Correct.

Q. And the sentence goes on?

A. Right.

Q. Is that what's commonly known as a "historical volatility"?

A. Yes, it is.

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Q. And why do you choose to use historical volatility?

A. It's the basis on which the Hillegeist paper assessed the probability of bankruptcy and showed it was better than the other models.

Q. Showed it was better than what other models?

A. Well, they make a comparison of this option model against something called a "Z-score model," another one called the "Olson model."

Q. Aren't those accounting-based methodologies?

A. Those are primarily accounting-based methodologies, yes.

Q. So those are not options-based methodologies, if I'm understanding?

A. They are not, right.

Q. So there wouldn't be a volatility figure in the accounting-based model?

A. That is correct.

Q. So does the study actually tell you to apply historical volatility as distinguished from implied volatility?

A. They base their measures on the

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historical volatilities and show that it gives you much more accurate predictions than either the accounting-based models.

Q. Is there actually a discussion within the Hillegeist article as to whether to use historical or implied volatility?

A. I don't remember that there was any discussion about implied volatilities. There may have been. I just don't remember.

Q. Okay. And are you saying that you actually saw them applying historical volatility?

A. They say they used historical volatilities.

Q. And I take it you don't know why they used historical volatilities?

A. Well, it's a fairly common thing to do.

Q. Right. Now, you're trying to assess a future probability of bankruptcy. Isn't that right?

A. Correct.

Q. Okay. Don't you think it's more appropriate to use a forward-looking volatility measure?

A. Sometimes those forward-looking

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volatility measures give you all different kinds of point estimates so that -- we're trying to measure what the volatility over a four-year period. Those implied measures are likely to give me a volatility estimate over three months or six months, something like that.

Q. So was it an ease-of-computation consideration that led you to use historical volatility?

A. I was trying to be consistent with the paper because the paper shows that this method dominates the other methods conditional on this procedure.

Q. Okay. You mentioned a -- I'm sorry. You were telling me the inputs that you used and, I don't think you had gotten up to outputs because I interrupted you. Please go head.

A. I know I got as far -- I got as far as the inputs. I think that's all you asked me.

Q. Okay. What were the outputs?

A. Well, the outputs -- from that, you can derive what the asset value and the asset volatility are as well as what the probability of bankruptcy is.

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Q. And that is the probability that assets will be less than debt on four years from whatever date you pick as your starting point?

A. Correct.

Q. Can you tell me -- in your note to -- note No. 8 under "Notes and Sources" on Exhibit 4 of your report, there's a sentence in note 8 that says, "Instead of the estimated asset return, I used the risk-free rate in four."

A. Right.

Q. The risk-free rate is one of the inputs?

A. Yes.

Q. And why do you use the estimated asset return instead of -- I'm sorry.

Why do you use the risk-free rate instead of the estimated asset return?

A. Well, what they do in the paper is, they use the historical -- the historical realized return on the assets. And sometimes that winds up being negative. And if it's negative, then they use the risk-free rate because you wouldn't expect assets to be priced to yield a negative return. The problem that you can get into when you use the estimated asset return is that if the historical

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estimated asset return has been high, then the probability of bankruptcy will be zero because using the historical number basically presumes that you'll continue to get that high estimated asset return. In Marvel's case, if you use the historical estimated asset return, you get a measure of zero financial distress cost no matter what you do. And so using the risk-free rate will provide some estimate of financial distress costs.

Q. So it wasn't that the typical reason that would drive you to use the risk-free rate, that asset returns are negative. It was the opposite end of the spectrum?

A. In this particular --

MR. ALLINGHAM: Object to the form of the question.

A. In this particular case, yes, it was not that asset returns were negative. It was asset returns were so high, there would be no likelihood of distress from the model.

Q. And did that give you any pause or concern as to whether that was a valid model to be using?

A. No. In fact, what this would do is, it

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would increase the probability of financial distress, so, if anything, it would increase the cost of financial distress.

Q. No. I understand what you did. I'm saying: Did you have any concern about whether the model was an appropriate model?

A. No, no. The model is used a lot by a lot of people.

Q. Had you applied this methodology before?

A. I talk about it in class.

Q. Which class is that?

A. My corporate valuation class.

Q. Okay. I think you said other people use this methodology?

A. Yeah, use a similar methodology, yes.

Q. Oh. Who is it who uses a similar methodology?

A. KMV, for example. KMV was bought by Moody's.

Q. Do you actually know the methodology that KMV uses?

A. You can't know all of it because some of it is proprietary. So we know parts of it, and parts of it are consistent with this, but then

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they don't tell you everything that you do.

Q. So you know that KMV uses a model in which -- parts of which are similar to the Hillegeist model?

A. Correct.

Q. Do you know anyone else who uses it, or parts of it, I guess?

A. There's a corporation called "LLC" that uses it. KMV sold their products to lots of banks who examine long portfolios and things like that using it, so it's a commercial product that's sold.

Q. KMV sold its proprietary product?

A. Correct.

Q. Okay. I'm talking about just this Hillegeist model. Is there anyone who uses that?

A. I know that Hillegeist has been approached by hedge funds and banks. I don't know whether any of them were ultimately implemented or not, but a lot of them were playing around with it.

Q. So as you sit here, do you know if anyone is using the Hillegeist model?

A. The Hillegeist version?

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Q. The Hillegeist version.

A. I mean, it's derived from the same theory as what KMV uses and LLC and all the others, but the exact form of the Hillegeist model, I can't tell you.

Q. Okay. And had you calculated probabilities of bankruptcy for a professional or academic purposes before this case?

A. Probabilities? No.

Q. This was your first occasion to apply --

A. Well, for academic purposes, yeah. In my class I have, yes. I'm sorry. I was thinking professional.

Q. So you had applied the Hillegeist version in class?

A. We talk about it in class, yes. We talk about the other models, too. We talk about the Olson model. We talk about the Altman model.

Q. Okay. I don't know if I'm getting hung up on semantics or what. When you say you talk about it, do you -- have you applied the model to any real world situation as opposed to talking about models?

A. Well, we come up with examples, and we

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teach the students what the inputs are and how the model works.

Q. Okay. Going back to your Exhibit 4, how did you pick four as the years to maturity?

A. That was the years on the Marvel III notes.

Q. And why did you pick February 15, 1994, as the date on which to assess probabilities of bankruptcy?

A. That was the date that the Marvel III notes were issued.

Q. I think you mentioned that you also have a panel that discusses the application of your model with the Marvel III notes. Can you tell me about that, in particular, whether it's different in some way?

A. Well, in those -- I run two scenarios where you make an assumption about -- that Marvel was going to have to issue -- I make the assumption that the indenture company -- the holding notes caused Marvel to have to increase its leverage. And so then the issue is: What would have been the expectation about the amount of leverage that Marvel might have had -- might

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have had to issue, given the Marvel III notes under the assumption that it was going to cause them to have to issue debt? So I look at three scenarios. The first scenario is just to see what analysts were saying about how much debt Marvel was going to issue, and that's not in this table. That's in the text. And the analysts were saying after the issuance of the Marvel III notes that they actually were going to retire debt, that they were going to pay down debt. If they paid down debt, then there's no increase in the financial distress costs in the probability of distress, so there's no economic harm.

Q. Okay. And if I look at your calculation with the Marvel III notes, I see one -- the equity volatility, there was an input without the notes, there was an output with the notes.

A. Correct.

Q. And why is that?

A. Well, one of the things that the equity volatility allows -- if you look over where you have the without the Marvel II notes, one of the things that you can figure out from applying the model is what the asset volatility is. So now I'm

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in February of 1994 in order to see what the result would be?

A. I think I alluded to this before. I said I did some sensitivity analysis. So, for example, in this particular case we hold the rate of interest constant at 6 percent even though we're increasing the amount of debt. One might argue that the cost of debt would go up a little bit if you increase the amount of leverage in the firm, so we ran scenarios at 7 and 8 percent, things like that.

Q. Before you came to this -- before you decided that you should use expected costs of financial distress as distinguished from actual costs of financial distress, did you consider any other methods for measuring harm?

A. The only other measure that you might be able to use for measuring harm would be to look at price responses on the days in which, for example, the Marvel III notes were issued or something like that. So, in other words, on the date on which something occurred -- right? -- you can see what the price response is on those days.

Q. But you didn't do any calculation of

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what actual injuries were sustained in 1995 or 1996?

A. Again, I estimated the October 17 date that we talked about.

Q. Other than that material.

A. Yes.

Q. Okay. Could you take a look at Exhibit 5 to Holthausen Exhibit 1, please? And what does that show?

A. Here I'm estimating what the costs of financial distress are, the expected cost of financial distress, the expected incremental cost of financial distress, to be more precise, which is a function of what the incremental probability of financial distress is in conjunction with, in panel A, the average of the 10 and 20 percent that comes out of Andrade and Kaplan, and in panel B the estimated cost of financial distress associated with the no-shock sample.

Q. Why --

A. I'm sorry.

Q. I'm sorry. Go ahead, please.

A. And I show that for scenario 2 and scenario 3.

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Q. What are you referring to here by the "no-shock sample"? Is that the same as the Andrade and Kaplan --

A. Yeah, that is the Andrade and Kaplan no-shock sample.

Q. And why are you showing a no-shock sample?

A. For the same reasons we talked about before, that Andrade and Kaplan are worried about in their paper that the 10 to 20 percent estimates that they get are an upper bound because they believe that that mixes economic -- those estimates mix the effect of economic distress and financial distress.

Q. And did you do any calculation -- perform any calculation using the Andrade Kaplan results for shock companies?

A. No.

Q. Had you considered doing that?

A. No.

Q. Can you explain to me what note 5 under "Notes and Sources" in Exhibit 5 means? Your table says, "The average cost of financial distress in percentage is zero," but then you have

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some positive numbers in note 5, and I'm not understanding how the positive numbers yield an average of zero.

A. Oh. Well, that's -- those are the results that come out of their study, which indicates that there would be no cost associated with financial distress.

Q. Oh. You're saying these are showing positive --

A. They're showing positive --

Q. -- financial distress costs?

A. Well, that's what comes out of their study, and so they infer from that that the financial distress is zero.

Q. So that's not your calculation; that's theirs?

A. The 5.6 and the 31.2?

Q. Correct.

A. Yes.

Q. Professor Holthausen, was Marvel's strategy to grow by acquisition relevant to its likelihood of financial distress?

A. Well, growing by acquisition doesn't lead you to financial distress.

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Q. Is it relevant to its likelihood of financial distress?

A. It would depend upon how you finance yourself.

Q. So is Marvel's acquisition strategy taken into account at all in your methodology that you take from the Hillegeist study?

A. Is it's which strategy? Its acquisition strategy?

Q. Yes.

A. No.

Q. So under the Hillegeist model as applied by you, all other factors equal, a company which has plans to make acquisitions is just as likely to suffer financial distress as a company without acquisition plans?

A. Well, except that it might affect the inputs into the model, such as equity volatility or something like that, or the asset volatility.

Q. If the plans are known on the date that you pick as your start date?

A. Yes.

Q. And is Marvel's financing strategy relevant to its likelihood of financial distress?

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A. Sure. How it chooses to finance itself will affect the probability of financial distress.

Q. So is Marvel's financing strategy going forward from February 15, 1994, factored into your model in some way?

A. Well, what I presume here in scenarios 2 and 3 is that they're actually going to increase the amount of debt that they have. And I look an ex-ante calculation about what's sort of the maximum amount debt that you might infer that they would be able to issue at that point in time.

Q. Why is it you're not using their actual debt levels?

A. Because this is an ex-ante calculation, nobody knew how many acquisitions they were going to do, nobody knew how much debt they would take on ultimately. This has to be a calculation based upon some expectation at the time that the holding company notes are issued.

Q. And that all goes back to the fundamental point that you mentioned this morning about your view that you measured the expectations as of February 15, 1994?

A. Correct.

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Q. Is the impact of the indenture covenants on Marvel after February 15, 1994, relevant to its likelihood of financial distress?

A. Well, what this calculation presumes is that the indenture covenants force Marvel to take on additional debt, and so this calculation is based on that presumption, and then looks at the increase in debt which would have been feasible at the time, given the Marvel credit agreements and some projection about its EBITDA.

Q. Okay. And is any actual impact of the indenture covenants factored into the model?

A. Well, actual -- I was asked to assume that the indenture covenants caused Marvel to increase the amount of debt, so that's the extent to which the indenture covenants affect calculation here because it's an assumption that the debt levels will go up because of the indenture covenants.

Q. Did you assess the probability of bankruptcy for any date other than February 15, 1994?

A. It's the probability that by the due date of the March -- you're standing at

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February 15, 1994. You have a certain amount of liabilities. What is the likelihood that you'll be bankrupt in the period between then and when the Marvel notes are due?

Q. I can see you did that. My question is simply whether you made that assessment or calculation for any date other than February 15.

A. Right. My point is, it goes to the end of the due date of the Marvel III notes.

Q. I'm not being clear. It's probably my fault.

Did you pick a start date other than February 15, 1994?

A. No.

Q. So the one and only scenario -- or all the scenarios you ran assumed February 15, 1994, as the start date?

A. Correct, because that was the date of the Marvel III notes. And Mr. Baliban said that as far as he was concerned, that was where all the harm came from, the Marvel III notes.

Q. Okay. Can you look at paragraph 18 of Holthausen Exhibit 1, please? And this is talking about the various scenarios that you described to

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me?

A. Uh-huh.

Q. Your scenario 1 is the expectation of analysts about the amount of debt that Marvel would have subsequent to the issuance of the Marvel III notes?

A. Uh-huh.

Q. And why did you hypothesize that scenario?

A. Because, again, it's an expectation of the future debt level, so these are analysts who were following the firm. They've read the 10Ks. They've talked to management. And so the issue is: What were they forecasting about the amount of debt that Marvel was going to take on?

Q. Were you assuming that the expectations of an analyst about the amount of debt that Marvel would take on were consistent with Marvel's own plans?

A. Again, I'm trying to calculate what an expected value is. And one of the ways to do that is to use information about expectations. So this is one of the scenarios I looked at because it reflects analysts' expectations of what is going

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to occur.

Q. I guess that's really my question, is: Why do you take analysts' expectation rather than for example MacAndrews & Forbes' expectations?

A. I don't have any data about MacAndrews & Forbes' expectations. If I did, I could rerun the model.

Q. Sure. Why do you not use the expectations of the management of Marvel?

A. I don't have any data from the management of Marvel about how much debt they were going to issue.

Q. So it's the availability of data that is a factor in constructing these scenarios?

A. Correct.

MR. ALLINGHAM: Object to the form of the question.

Q. Okay. You mention in, I think, the next paragraph, 19, and I think you told me this before, that after issuance of the Marvel III notes, analysts expected Marvel to reduce its debt level?

A. Yes.

Q. And are the analyst reports that you

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looked at just the once you list in paragraph 19, or are there others?

A. No. Those are the ones I looked at.

Q. Okay. And what was the time frame of the analyst reports you looked at?

A. I was trying to find something reasonably close to when the Marvel III notes were issued.

Q. I'm sorry. Go ahead.

A. That's it.

Q. The last one you cite was on July 21, 1994?

A. Correct.

Q. Okay. And was there any particular reason you stopped at that date?

A. No. I was just trying to -- again, I was just trying to find things that were, you know, consistent with the time period when the Marvel III notes were issued.

Q. Is there a reason you didn't look at reports from August of 1994 in particular?

A. No.

Q. So if Marvel made a huge acquisition, that would just be coincidence?

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A. Yes. Well, I'm trying to figure out what were the expectations at the time these notes were issued.

Q. Do you think that Marvel's board didn't know that it was going to make an acquisition in August -- in July 21 of 1994?

A. I don't know what the board knew. I have no personal knowledge of what the board knew.

Q. Did you consider why analysts believed Marvel would reduce its debt after the Marvel III note issuance?

A. No.

Q. And did you consider why Marvel acted contrary to analyst expectations as of that time?

A. No, I do not.

Q. And did you consider whether it was in Marvel's best interest to finance acquisitions with bank debt rather than equity?

A. No, I did not do an analysis of that.

Q. Could you take a look at paragraph 20 of Holthausen Exhibit 1, please?

A. Uh-huh.

Q. Can you help me out here with understanding what you're doing in paragraph 20?

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Are you considering whether it was in Marvel's best interest -- I'm sorry.
Are you assuming that Marvel's own credit agreements would still have been in place had the holding company notes never been issued?
A. No. I'm assuming that the Marvel -- I'm just assuming that the Marvel credit agreements are in place.
Q. With or without the holding company notes?
A. With or without the holding company notes.
Q. And do you think that it is a reasonable assumption to assume that the credit agreements would have been in place, absent the holding company notes?
A. Yes.
Q. And why is that?
A. Because they had credit agreements before the holding company notes.
Q. Could you please take a look at paragraph 24 of Holthausen Exhibit 1?
A. Uh-huh.
Q. Okay. You say that Mr. Baliban has to

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make a number of assumptions in order to use the decline in Marvel's stock price on November 12, 1996, as a measure of the minimum harm to Marvel. Do you see that?
A. Uh-huh.
Q. Okay. Are all the assumptions you're saying he must be making listed in paragraph 24, or are there others that are not listed here?
A. I believe that's all the assumptions. The second assumption incorporates two things. One is that there are many announcements that take place on that day, and the second is that I believe that the Andrews offer provides the market with information. So both of those are incorporated in that second assumption that no other value-relevant news comes out about Marvel. And it goes on to talk about the two assumptions, about the financial distress certainty and the sole causation assumption as well, right. So all those assumptions are there.
Q. Is it your view that the expected cost of the indenture covenants at the time the notes were issue is relevant to Mr. Baliban's analysis of the damages to Marvel in November of 1996?

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A. I'm sorry. You're going to have to repeat that again.
Q. Sure. One of the assumptions you list in your paragraph 24 is, you say that "Mr. Baliban's estimate is not based on the expected cost of the indenture covenants at the time that those notes were issued."
Do you see that? It's like the last sentence --
A. Right.
Q. -- paragraph 24. I assume it's your view that the expected cost of the indenture covenants at the time the notes were issued is somehow relevant to Mr. Baliban's analysis of the damages to Marvel in November of 1996?
A. Well, it depends on whether you want to do an ex-ante calculation or an ex-post calculation. If he wants to do an ex-post calculation, then he's got to obviously ignore the expectation piece. I don't even think doing an ex-post analysis, you can ignore the sole causation piece.
Q. How is the expected cost of the indenture covenants -- of the indenture covenants

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at the time they were issued relevant to Mr. Baliban's analysis of a minimum damage level in November of 1996?
A. I think I just answered that, but my point is that he believes that doing an ex-post analysis is an appropriate way to measure damages. I've said I think it has to be an ex-ante measure.
Q. I'm with you so far.
A. Okay. So if you use an ex-ante measure, then you have to take into consideration the expectation that it would occur at the time the notes are issued. He is doing an ex-post measure, so he doesn't take into consideration the expectation. My whole point is just back to the same thing, and that is that I think we should be doing an ex-ante measure, not an ex-post measure.
Q. I see. So it's that fundamental point of departure between you and Mr. Baliban?
A. It's the fundamental point of departure, correct.
Q. Are you able to take his analysis of market impact in 1996 on its own terms and tell me whether the expected cost of the indenture covenants at the time they were issued has

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anything to do with that?

A. I'm not sure what you mean, "on its own terms." Are you asking me if I wanted to do an ex-post analysis like his, do I have to take into consideration the expectation?

Q. Yes.

A. No, because he's assuming that it's certain that they will fail. So if you want to make the certainty assumption, then you don't have to take into consideration the expectation.

Q. Okay. You mention in paragraph 24 and a little higher up in paragraph 24 that -- you say that "Mr. Baliban has to assume that November 12, 1996, was the first time that the market knew that Mr. Perelman," P-e-r-e-l-m-a-n, "or Perelman-controlled entities would not provide Marvel with an equity infusion without a waiver of the indenture covenants from the holding company noteholders."

Do you see that in paragraph 24?

A. I'm sorry. I just found it.

Q. Okay. Let me know when you're with me. You're with me?

A. Uh-huh.

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Q. Oh, okay. Is it your belief that that was not the case?

A. It's my belief that is not the case.

Q. And why is that?

A. Because I believe the market found out prior to November 12 through the October 17 announcement, and I believe that that's buttressed by the fact that the analysts were talking about it subsequent to October 17, but before November 12.

Q. You believe that the market learned before November 12 that Mr. Perelman would not make an equity investment in Marvel unless the holding company noteholders waived the indenture covenants?

A. Yes.

Q. Okay. Let's take a look at the October 17 announcement.

MR. GOLDWATER: Can I have this marked as Holthausen Exhibit 3, please?

(Announcement dated October 17, 1996, is marked as Holthausen Exhibit 3 for Identification.)

Q. Okay. I show you what's been marked as

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Holthausen Exhibit 3 and ask you to please take a look at that.

A. Okay.

Q. Okay. Is that the October 17 announcement that you were just referring to?

A. Correct.

Q. And what in that announcement would alert the market that Mr. Perelman would not make an equity investment in Marvel unless the holding company noteholders waived the indenture covenants?

A. Well, I think there's two things in here that are talked about. One is the fact that there's going to have to be an agreement with the Marvel holding company noteholders and the Andrews Group on the terms of that purchase and the fact that the collateral that is in those is going to be substantially diluted, which is in the next paragraph. I think any reasonable inference from those things is that there's going to be substantial negotiations that are going to have to take place with the Marvel company bondholders, the holding company bondholders.

Q. Okay. So you think the inference that

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the market would take from this is that there's going to be a negotiation. A negotiation between who about what?

A. I think there's going to be -- I think there's going to be a lot of negotiations. I think there's going to be negotiations with Marvel, the banks, with Andrews, and with the Marvel holding company bondholders. So -- and those were going to revolve around different things, in all likelihood, so that negotiation with the banks is going to be one thing, and negotiation with the noteholders is going to be something else.

Q. And what's the "something else" that you see in the October 17 announcement?

A. With the noteholders?

Q. Yes.

A. Well, I mean, the collateral is going to be substantially diluted. And so what that means is, the value of the collateral is going to fall substantially if this transaction goes through.

Q. Anything else?

A. And if it goes -- if the delusion is substantial enough, it's going to violate the

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50 percent majority ownership rule. So it's going to depend on how substantial the delusion is, but I think it certainly puts the market on notice of that issue.

Q. Does the October 17 announcement say anything about the indenture covenants?

A. It does not say anything directly about the indenture covenants.

Q. Now, in paragraph 29 of your report, Holthausen Exhibit 1, the sentence that carries over from page 17 to 18, you say, "It's not true that the market was unaware of the potential role of the holders of the holding company notes regarding an equity infusion from entities controlled by Mr. Perelman."

Do you see that?

A. Uh-huh.

Q. What do you mean by "the potential role of the holders of the holding company notes"?

A. Well, that they were going to have to be in agreement -- they were going to have to negotiate with the Andrews Group, and they were going to have to agree to the terms with the Andrews Group about the delusion that's going to

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take place.

Q. Okay. The potential role was undefined, I take it?

A. Well, I think I just defined it, but, yes. I mean, there could have been other things that they could be negotiating as well.

Q. Okay. And the outcome of this negotiation could be good, bad, or indifferent. We just don't know?

A. Yeah. I mean, anything could happen associated with that. That's correct.

Q. Okay. And do you believe, Professor Holthausen -- I think you've done some work in this area -- that the specificity of the information in the announcement has a bearing on its market impact?

A. What do you mean by "specificity" in this particular case?

Q. The amount of information provided on the subject that you are opining about.

A. Well, I think there -- you know, the more information that's given, the better, but I think there's a lot of information here about the role that the holding company notes are going to

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play in this negotiation.

Q. Anything beyond what you've already told me?

A. No. I think I've already articulated what I think it says.

Q. Okay. And do you know if the market views that favorably, unfavorably, or otherwise?

A. Views what favorably or unfavorably?

Q. Whatever it is you're saying they learned about the role of the noteholders.

A. Well, there's a price response on that day that's negative. It's not statistically significant in terms of how people normally characterize statistical significance, but there is a price response on that day, and I think the value of the equity falls $25 million roughly.

Q. When you say, "It's not statistically significant," can you tell me what it means? Not meeting a particular confidence level?

A. Not meeting a particular confidence level.

Q. Is that the 95 percent confidence level?

A. I forget exactly what it was. I'm not sure it even met the 90, but -- I just don't

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remember what it was.

Q. Okay. Professor Holthausen, did investors learn anything about the indenture covenants in particular in the Marvel parent or Marvel III notes from the October 17 announcement?

A. There was nothing stated in particular about the indenture covenants in this announcement, but I think it's a reasonable inference to draw that they would understand what those were, that there was some role for those. And, in fact, the analyst reports that come out between October 17 and November 12 talk about the indenture covenants.

Q. These are the reports I haven't seen yet?

A. Yes, they are.

Q. Did investors learn from the October 17 announcement that Mr. Perelman would not make an equity investment in Marvel unless the noteholders agreed that the stock he bought would not be subject to the indenture covenants?

A. They did not learn that directly.

Q. Okay. You said you did some analysis to determine whether the information in the

Q. Yes.
A. Yes, that's my understanding.
Q. Okay. And if, indeed, he did control for the third quarter earnings information, do you have any other criticism of his report based on the announcement of that third quarter earnings information?
A. Just the third quarter earnings information or all the other information?
Q. Just the third quarter.
A. Well, to be honest, I'd have to go back and look more carefully at what he did to know whether I thought he did it correctly or not. Assuming he did it correctly, then I wouldn't have any qualms with it.
Q. As you sit here, I take it you can't remember --
A. I cannot remember how he did it.
Q. Okay. Could we take a five-minute break?
A. Sure.
THE VIDEOGRAPHER: If we can also -- when we go off the record, I have a question. The time now is 2:57 p.m., and we're going off the

record.
(There is an off-the-record discussion.)
THE VIDEOGRAPHER: This concludes the tape No. 2 of the videotape deposition of Robert Holthausen. The time now is 2:58 p.m., and we're going off the record.
(There is a recess taken.)
THE VIDEOGRAPHER: This the beginning of tape No. 3 in the videotape deposition of Robert Holthausen. The time now is 3:09 p.m., and we're back on the record.
BY MR. GOLDWATER:
Q. Professor Holthausen, would you just take a look at paragraph 33 of Holthausen Exhibit 1?
A. Okay.
Q. Okay. You mention in that paragraph that "Marvel announced earnings guidance for the upcoming fourth quarter of 1996."
Do you see that?
A. Correct.
Q. In your view, is this announcement of fourth quarter guidance significant to Mr. Baliban's report in some way?

A. Well, I think they're disclosing bad news here. Expectations had been roughly 40 cents a share. They're saying here that the loss is going to be 52 to 57 cents a share. I think that would be viewed as negative news by the market.
Q. Was there something that Mr. Baliban should have done about this announcement of company guidance that he didn't do?
A. Well, the issue is whether, you know, you can apportion all these things out or not amongst all these different announcements, which is difficult to do. There's a long literature on management forecasts which basically says that if managers forecast bad news, there are negative price responses to them.
Q. You've seen studies specifically addressing company guidance?
A. Management forecasts. They're the same thing. There are studies on point estimates. There are studies on range estimates, all kinds of studies.
Q. Are you able to tell me the name or author of any of those studies?
A. There's a study by Steve Penman, there's

a study by Greg Waymire.
Q. How do you spell that?
A. Waymire?
Q. Yes.
A. W-a-y-m-i-r-e. There's probably -- I don't remember them all off the top of my head. There's probably 10 or 15 studies on management forecasts that look at different elements of the forecasts. Some look at price responses. Some look at analyst reactions to them.
Q. And these are -- to make sure we're talking about the same thing, these are forward-looking company guidance as distinguished from announcements of earnings for periods of time that have already come and passed?
A. Forward-looking company guidance in your terminology, yes.
Q. Do you have a view, Mr. Holthausen, as to whether the announcement of this guidance affected Marvel's stock price on November 12, 1996?
A. I believe it would have affected it negatively, but I have not attempted to measure that.

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Q. What's the basis for your opinion if you haven't attempted to measure it?

A. All the prior studies that indicate when managers release negative forecasts, there are negative stock price reactions to them.

Q. Do you believe it's relevant whether announcements of company guidance have in the past impacted stock price?

A. Maybe you could rephrase that for me. Are you saying if Marvel had issued guidance in the past?

Q. Yes.

A. It's certainly possible the issue would be whether you have enough observations, whether you could control for all the other things that were taking place there. It's not necessarily a simple thing to do for an individual company because of the number of times that companies often give guidance.

Q. And in your review of the analyst reports that you looked at, did you see any where they were talking about the -- in the wake of all of the news that came out on November 12, did you see any where they were discussing the

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implications of the fourth quarter company guidance as distinguished from the other news items that came out that day?

A. I believe there were analysts who basically lowered their expectations of earnings based upon this.

Q. Which analysts are those?

A. I don't remember off the top of my head.

Q. Do you know if those reports came out on November 12 as distinguished from some period of time after November 12?

A. I believe they were after November 12.

Q. Okay. Okay. Would you please take a look at paragraph 34 of Holthausen Exhibit 1?

A. Uh-huh.

Q. You say there that Marvel announced that it was "evaluating whether there had been impairment to goodwill and other intangible assets, and is considering restructuring and other actions, all of which could result in substantial 1996 year-end charges."

Do you see that?

A. Uh-huh.

Q. In your view, was there something

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Mr. Baliban should have done with this information that he didn't do?

A. Well, the issue, again, is that this -- there's potential -- this is potentially negative news to the market. Market rate may have responded negatively to the news that it was evaluating this impairment and evaluating alternative restructuring plans. And if you want to infer something about the price response to other news that came out that day, you would have to try to figure out how to control for this.

Q. When you say you would have to control for it, you're assuming it has a market impact?

A. Correct. If it doesn't have any market impact, then you wouldn't have to control for it. But if it does have a market impact, you'd have to try to figure out how you could control for it.

Q. Understood. And is it your view that this news had a market impact?

A. Certainly news like this in other studies. There have been studies on impairment and studies on restructuring in the past, and a lot of those indicate negative price responses. Now, most of those actually look at -- I think

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they actually look at restructuring announcements. I don't know whether there's been a study that has tried to look at -- were evaluating whether to restructure or evaluating whether to impair. I'm not sure there's enough sample size that will allow you to do that study.

Q. So you're not aware of a study that evaluates the market impact, if any, of announcements that a company is evaluating whether to take an impairment or restructuring?

A. Not off the top of my head, right.

Q. And what are the articles that you were referring to when you said there are articles that talk about announcements of actual impairments and restructuring charges?

A. There's an article by Jennifer Francis.

Q. F-r-a-n-c-i-s?

A. Uh-huh. Oh, what's his name? There's an article by a guy who was at Cornell when he wrote it. I can't remember his name. I'm sorry. It escapes me off the top of my head.

Q. Okay. You're aware, aren't you, that there are a lot of articles that show that announcements of restructuring or impairment

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charges have positive market impacts?
A. There's mixed evidence in the literature about that.
Q. Okay. And are you able to say, as you sit here, whether this particular announcement had a market impact on Marvel?
A. No, I'm not.
Q. I think you may have told me this already, and I apologize if you did. But did you do any analysis of whether or to what extent Marvel's announcement that it was evaluating whether to take an impairment to goodwill and was considering restructuring actions affected Marvel's stock price?
A. This particular announcement?
Q. Yes.
A. No. There's no way to examine this particular announcement because it's not in isolation.
Q. Okay. Would you please take a look at paragraph 35 of Holthausen Exhibit 1? You mention in that paragraph that Marvel announced on November 12, 1996, that "as a result of the defaults under its credit agreements, which had

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been announced the prior month, Marvel was reclassifying the balance of its long-term debt to current liabilities"?
A. Correct.
Q. Okay. And what's the significance of that announcement, if any, to Mr. Baliban's report?
A. Well, the issue, again, is whether or not this has negative implications for Marvel's stock price. One of the things that you learn from this is that they haven't been successful in obtaining a waiver, and they must not be on the cusp of getting that waiver either because, otherwise, they would postpone the reclassification of this until their 10Q was due. So if they thought they were going to get one in the next day or two, they would be holding off on this announcement and not going forward with it. But what's obviously happening here is, they know they're not going to get it in the short term. Generally accepted accounting principles will require this reclassification in the absence of a waiver or in the absence of fairly definitive information that the waiver is forthcoming.

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Q. Was there something that Mr. Baliban should have done with this information that you think he didn't do?
A. Well, again, this is something that has potentially negative news on the stock price, and he's not adjusting or controlling for that to the extent that it does have a negative impact.
Q. And in your -- do you have an opinion as to whether this announcement did have an impact on Marvel's stock price on November 12?
A. Well, it certainly wouldn't be considered good news. Whether it actually affected market expectations is hard to know because you don't know what the market's expectation was on that date, but you certainly couldn't classify it as good news, and it may have had a negative impact on stock price.
Q. I understand your view that it may have. My question is: Are you offering an opinion as to whether it did have a market impact on Marvel?
A. There's no way to definitively separate all these out from a single announcement.
Q. Okay. So if I'm understanding you, you're not offering an opinion as to whether this

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particular item of news impacted Marvel's stock price on November 12?
A. I'm saying that it could have, and it hasn't been controlled for.
Q. Maybe I missed something. I thought we established earlier that you can't control for something unless you assume it has a market impact. Is that correct? There's nothing to control for unless a news item has a market impact?
A. Sure, right, right.
Q. Okay. So the first question is whether it has a market impact, and that's what I'm asking you. Did this news item have a market impact on November 12?
A. It potentially has a market impact, but there's no way to know that from one announcement that takes place in the context of eight other announcements.
Q. Professor Holthausen, have you done any analysis to determine whether or to what extent Marvel's announcement that it was reclassifying long-term debt affected Marvel's stock price on November 12?

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A. As I said, there's no way to do that analysis, given that all these occurred at the same time.

Q. So if I'm understanding you, you did not do any such analysis?

A. Correct.

Q. By the way, if that had a market impact, if we assume that it had a market impact, would you expect a corresponding impact on the market price if and when Marvel announced that it had been able to obtain a waiver from its banks?

A. At the same time period?

Q. No, no. If we assume that this news about reclassifying long-term debt was significant to the market to the extent that it had a market impact, wouldn't we also expect that if and when Marvel did obtain bank waivers, there would be a market impact in the other direction?

MR. ALLINGHAM: I object to the form of the question.

A. I don't think you necessarily could infer that because it all depends upon what the market's expectations are. There are lots of times when companies need to obtain waivers, and

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everybody thinks they're going to be able to obtain a waiver. And when they obtain the waiver, there's no significant price response because everybody thought it was going to be pretty easy for them to obtain a waiver.

Q. Okay. And does the same hold true for November 12, that it depends on what the market's expectations were?

MR. ALLINGHAM: Objection to the form of the question.

A. All --

Q. Go ahead.

A. Whether or not anything responds depends upon what the market's expectation are about the news.

Q. Okay. Would you please take a look at paragraph 37 of Holthausen Exhibit 1?

A. Okay.

Q. You see the third sentence of that paragraph? You say that the Andrews Group proposal "likely provided the market with information about the value of the company"?

A. Uh-huh.

Q. What information are you talking about?

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A. Well, the offer of 85 cents a share, which is significantly below the price prior to November 12, is an offer from somebody who would be considered an insider at the company and would presumably have fairly detailed knowledge about the company.

Q. And did the announcement of the 85-cents-a-share offer affect Marvel's stock price?

A. Well, we know that Marvel's stock price responded on November 12, and we know that a lot of things occurred on November 12. I mean, it went from whatever it was, 4 5/8 to 275 or whatever. So there are a lot of things that are occurring on that day, including this particular announcement.

Q. Did this particular announcement affect Marvel's stock price?

A. I believe this announcement would affect Marvel's stock price.

Q. And how do you know that?

A. I don't know it with certainty. I think that when you have an insider who is offering 85 cents a share where the current price is 4 5/8,

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this is a smart investor who's done a lot of deals. I'm pretty sure this offer would be subject to going through a whole fairness opinion. And I presume they weren't just making an offer, you know, that they knew was going to get rejected. And so if this is what he believes is a value that he would be willing to pay for this company, then I think that's going to give the market some information about what the value of Marvel's stock price is.

Q. Have you done any analysis of whether or to what extent the announcement of the terms of the Andrews Group proposal, in other words, the 85 cents a share, affected Marvel's stock price?

A. Again, there's no way to disentangle all of these announcements which are occurring simultaneously.

Q. Okay. In Mr. Baliban's report he expressed the opinion that the 85-cent price per share offered by Andrews Group was structured in order to protect Mr. Perelman's 80 percent position in Marvel's stock. Does your report address Mr. Baliban's opinion on that subject?

A. I don't talk about that particular issue

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in my report.
Q. Okay. And in Mr. Baliban's report he expresses the opinion that the 85 cents per share offered by Andrews Group was not reflective of Marvel's value. Does your report address Mr. Baliban's opinion on that subject?
A. Again, what I said here was, I think that the market responded to this information. It's clear that the market didn't think that Marvel was worth 85 cents a share because the stock price doesn't drop all the way to 85 cents a share. But I think the market learned from this and revised its expectations about Marvel based upon this offer.
Q. Did you do any analysis to determine what the value of Marvel was on November 12, 1996?
A. A fundamental value based upon discounted cash flows or something like that?
Q. Or anything else.
A. No, I did not.
Q. And you may have told me this. Do you have an opinion as to how -- are you offering an opinion as to how the 85 percent share offer price was derived, or is that outside the scope of what

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you're doing?
MR. ALLINGHAM: Objection to the form. You said "the 85 percent" --
MR. GOLDWATER: Oh, I'm sorry. My mistake. I'll restate it.
Q. Are you offering an opinion as to how the 85-cent-per-share price was derived?
A. The 85-cent price per share was derived by the Andrews Group based upon presumably what it thought the valuation was.
Q. Okay. Do you have an opinion whether the 85-cents-per-share offer price in the Andrews Group proposal was itself a product of the indenture covenants?
A. I don't think it had to be a product of the indenture covenants because Mr. Baliban's calculation presumes that you're going to put in $350 million. There would be nothing that -- I mean, they could have put in more money if they had wanted to for the same number of shares. So if they wanted to get this transaction done and they thought that 85 cents a share wasn't a reasonable valuation, but they wanted to get the transaction done, they could have put more than

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$350 million in. Mr. Baliban takes this given that $350 million is the right amount of money to put in.
Q. I don't understand what you just told me. You're saying that Andrews Group could have chosen to put more money in?
A. If they thought -- if they wanted to have the 80 percent -- okay? -- and they wanted to, you know, have a transaction that was more likely to be approved because if 85 cents was too low a share price, too low a value, they could have put more money in.
Q. Oh, I see. They could have increased the share price?
A. Sure --
Q. I see.
A. -- which would have meant that they would have had to have put more money in if they wanted to retain an 80 percent ownership.
Q. And if they wanted to have the transaction approved, wouldn't it increase the likelihood of that happening if the offer -- if the share price was closer to the market price?
A. Sure. If they had offered more,

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potentially it might have gotten approved, but -- and my point is that they knew this was going to have to go through a whole process in order to get approved. And I presume they just weren't wasting their time by putting out an offer that was so far below what they perceived to be the market value of this company.
Q. Why do you presume that?
A. Well, why would I waste my time putting forward an offer that I knew would never go through? These are, you know, rational people. They know a lot about the processes at which this is going to take place. Buying 80 percent of the company, it's hard to believe you're not going to get a fairness opinion associated with this.
Q. Have you done anything, looked at documents, talked to people, done any economic analyses to try to determine how the 85-cent-per-share offer price was derived?
A. I've not seen any documents.
MR. GOLDWATER: Could I have this marked as Holthausen-4? You know what? We don't need to do that. I'm going to give you another piece of paper to mark. May I have this piece of paper

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marked as Holthausen-4?
(Press release dated November 12, 1996, is marked as Holthausen Exhibit 4 for Identification.)
Q. I show you what's been marked as Holthausen-4 and ask you to please take a look at that.
A. Okay.
Q. If you look at the second page of Exhibit 4 -- by the way, this is the announcement on November 12, 1996, of Marvel's receipt of the Andrews proposal. Is that right?
A. That's what it says.
Q. Okay.
A. It's not the Andrews proposal. It's not the Andrews proposal announcement.
Q. What is it?
A. It looks like a report that somebody has made about the Andrews proposal.
Q. Oh, I see what you're saying. It's not a document prepared by Andrews. It's Marvel's announcement that --
A. It's not the press release from the Andrews Group.

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Q. It's the press release from Marvel?
A. Okay.
Q. Okay. And if you look at the second page of Exhibit 4, you see the first full paragraph. The last sentence says, "The Andrews investment is subject to the satisfactory resolution of a number of issues under the Marvel parent holding company indentures, including that any Marvel common stock purchased by Andrews not be subject to the liens thereunder."
A. Uh-huh.
Q. Okay. You don't mention that in your reports. I just wanted to ask you: Did the announcement -- you know what? I'll do this together with another piece of this. The third paragraph of that, on that second page of Exhibit 4, "In our view, the Andrews investments represents a significant opportunity for Marvel and its stockholders," do you see that paragraph?
A. Uh-huh.
Q. It goes on, "The Andrews investment would provide Marvel with desperately needed liquidity and financial flexibility. As such, it is a fundamental predicate to a financial

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restructuring, essential if Marvel is to resolve its current difficulties and have the opportunity over time to prosper."
Okay. Those two parts of the November 12 announcement are not mentioned in your reports. I just wanted to go over them with you. Did the information in those two paragraphs, in your opinion -- do you have an opinion as to whether or not the announcement of that information affected Marvel's stock price?
A. Well, the first paragraph talks about -- it's going to require consents, etc., from the Marvel credit agreements. I believe that was already said in the October 17 announcement --
Q. Yeah, I agree with that, so I didn't talk about that.
A. -- that that would be necessary.
Q. I didn't even read that sentence.
A. Okay. I'm sorry. I'm looking at paragraphs. Okay.
Q. Okay. It's the sentence beginning "moreover."
A. Okay. So then, the issue here is whether or not -- "a number of issues under Marvel

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parent holding company indentures, including any Marvel common stock purchased by Andrews, not be subject to the liens thereunder." The --
Q. Your question is just whether you have a view as to whether that affected Marvel's stock price.
A. Well, there was already -- you know, the analysts were already talking about the issues of dilution and the potential that Perelman might have to put up some other kind of collateral because of the dilution that was going to take place. I think it's fair to say that the market knew in advance of this that there were going to be negotiations with the noteholders about the indenture covenant agreements and the -- and the effect of the dilution on the collateral. Whether or not this particular piece of it was known or not, certainly the dilution was going to be an important component that was going to have to be negotiated with the noteholders. And the analysts were talking about how this was going to be a, you know, a significant sticking point in what was going to go on.
Q. Yeah. My question is whether you have a

view -- and maybe you don't -- as to whether this particular item of information affected Marvel's stock price?

A. I think this was largely known by October 17, but, again, it's impossible to disentangle all these announcements from one another.

Q. So you can't say, as you sit here, whether it did or it didn't?

A. Whether it had some incremental impact relative to the October 17 announcement?

Q. That's not my question. As you sit here today, can you tell me: Do you have a view as to whether that particular item affected Marvel's stock price?

A. I think that most of this information was out on October 17.

Q. Does that mean your answer is you don't think it did?

A. I don't think this was going to have a very significant impact because of all these issues had been talked about previously.

Q. And have you done any analysis of whether or to what extent the announcement of that

information affected Marvel's stock price?

A. No.

Q. You mentioned -- by the way, did the November 12 announcement that we're looking at, this Holthausen Exhibit 4, did that change the mix of information in the market as to who would be negotiating and about what?

A. No. I think the players are pretty much the same because it's Andrews, Marvel, the banks, and the holding company noteholders, so I don't think the players have changed relative to what the October 17 announcement said. It does talk about the boards of directors of both Marvel and Andrews, but I don't think that would be a surprise to the market, given the announcement on the 17th. Maybe I'm missing something, but I don't think it changes the players.

Q. What in this November 12 announcement would be signaling to investors that Mr. Perelman was inviting a negotiation with the noteholders?

A. Was inviting a negotiation?

Q. I'm trying to understand. You've told me that you think that the market understood this to be inviting a negotiation of some sort that

somehow the noteholders would have a part in. What is it in this announcement that leads you to that?

A. Well, there's the sentence that we were just talking about that says that the Andrews investment is subject to a satisfactory resolution of a number of issues under the Marvel parent holding company indentures, which I believe is this same kind of stuff that you learned in the October 17 announcement.

Q. What kind of stuff -- the "same kind of stuff," what do you mean by that?

A. I mean, we already talked about in the October 17 announcement how there were going to have to be negotiations with the noteholders in order for that to go through.

Q. Okay. My recollection of what you said about October 17 is somehow we would have to infer what the negotiation would be about because I didn't talk about indenture covenants or things like that. Is that consistent with your understanding or your recollection?

A. Well -- but it did talk about negotiations taking place with the noteholders of

the holding company notes.

Q. Well, it didn't actually mention a negotiation. You introduced that term. What I'm trying to figure out is, since you introduced the "negotiation" term, what it is that you thought was -- whether you thought something was changing as a result of this November 12 announcement.

A. Maybe I'm not understanding your question. Okay? When I go back and I look at Exhibit 3, the sentence says, "Proposal would be subject to an agreement among Marvel, its banks, the holders of certain Marvel holding company bonds, and Andrews Group on the terms of the Andrews Group purchase."

Q. Right.

A. So all I'm saying is that all of those players that were named in October 17 are named here.

Q. Right.

A. And any players that are mentioned here that are not part of October 17th are the boards of directors of Andrews and Marvel, which I think everybody would have inferred would have been involved anyway, so --

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Q. And is there anything about -- when Exhibit 4 says that "The Andrews investment is subject to resolution of some issues under the holding company indentures, including that any Marvel common stock purchased by Andrews not be subject to the liens thereunder," is that signaling to you that Perelman is inviting a negotiation on that subject?

A. Maybe we're speaking at cross purposes because of the word "negotiation," but there's going to have to be some satisfactory resolution of that. The holding -- the holding company noteholders can say yes, they will or no, they won't. I mean, I don't know what you mean by -- what you're getting at with the word "negotiation." Obviously they have to resolve this issue.

Q. In October 17 the Andrews Group announces that it has a rescue plan that it intends to propose, without giving any details. Is that fair?

A. Without giving details, for example, of the price per share --

Q. Exactly.

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A. Okay, yes.

Q. Okay. And on November 12 the Andrews Group tells Marvel that if there's going to be any rescue plan, it's contingent on the noteholders waiving the liens of the indenture covenants. Is that also fair?

A. It does say that on November 12, but, as I said before, I think it's pretty obvious from the October 17 announcement that the negotiations with the noteholders are going to have to be about those indenture covenants. And the analysts went on to talk, for example, about the majority provisions in the indenture covenants.

Q. On November -- these are the analyst reports that you mentioned earlier?

A. Uh-huh.

Q. Okay. And I think you told me these were after November 12?

A. No. They were after October 17 and before November 12.

Q. And before November 12. Okay. Did you believe, Professor Holthausen, that the market would have understood the November 12 announcement -- this Holthausen Exhibit 4, that

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it's proposal was such -- that the Andrews proposal was subject to a waiver of liens under the holding company indentures -- to be inviting a negotiation on that subject? In other words, Perelman's open to it not being subject to the liens? I'm sorry. That Perelman's open to it being subject to the liens? It's really an open item for discussion?

MR. ALLINGHAM: Objection to the form of the question.

A. I have no idea whether Perelman wanted to negotiate that point or not.

Q. No. Of course you don't. I'm asking you whether, you know, as a reasonable market person who is looking -- looks at things like market impact, do you think that investors in the market would have understood Perelman to be saying, "You know, I'm really open to a negotiated resolution of this. And maybe they'll be subject to the liens and maybe they won't. It's really something I'm happy to discuss with noteholders"?

A. Well, again, I have no personal knowledge of what Perelman was thinking. You can imagine, however, that Perelman would be

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interested in trying to do something to save this company. And whether he thought that this was -- you know, he was going to make this one offer and that was it and not change? I can't speak to that.

Q. Yeah. You're personalizing it in a way that I'm not, that I'm not. I'm not talking about Mr. Perelman in his heart of hearts contends. What I'm asking you is whether an investor who sees this announcement would understand. It's irrelevant what Mr. Perelman in his heart of hearts wants to do. Would an investor who's deciding whether to buy, sell, or hold Marvel stock read this announcement and think, "Gee, it sounds like Mr. Perelman is really open to negotiation on the subject of whether an equity investment would or wouldn't be subject to the lien of the holding company indentures"?

MR. ALLINGHAM: Objection to the form of the question.

A. I mean, if I read the sentence, it just says "subject to the satisfactory resolution of a number of issues," but it doesn't say that it has to get resolved, how it's going to get resolved.

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I mean, it is an issue on the table.

Q. Do you see any analysts say that Mr. Perelman -- predict that Mr. Perelman would be willing to make an investment that wasn't subject -- I'm sorry -- that was subject to the lien of the holding company notes?

A. I don't remember any analyst saying that.

Q. Let's move on. Could you take a look at paragraph 40 of your report, Holthausen Exhibit 1, please?

A. Uh-huh.

Q. You talk about a computation of a "prudent investor rate for various time periods using simple interest" there. Do you see that?

A. Yes.

Q. Okay. And are you expressing an opinion as to whether this is the appropriate interest rate to be applied to any measure of damages in this case?

A. No.

Q. Just acting --

A. I was asked to be a calculator, and that's what I was.

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Q. Thank you. You mentioned, I guess, in the penultimate sentence of paragraph 40 that "Certain judgments are required to perform an actual calculation of a prudent investor rate."

A. Correct.

Q. Could you direct me on Exhibit 6 to which of the -- what parts of the calculation are the products of judgment as opposed to something else?

A. Okay. So if you look at one, the one-year certificate of deposit --

Q. Uh-huh.

A. -- you can see that the data that we found had six-month CD yields for a while, and then 12-month CD yields.

Q. Where would I see that?

A. 1B, footnote 1B. We could not find 12-month CD yields going all the way back through this time period.

Q. Oh, I see what you're saying.

A. So what did we do? We measured -- over the time period where both series existed, we measured what the yield difference was between the 12 month and the six month, the average, and we

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added that to the six month in the period where the 12 month didn't take place.

Q. Are there any other instances where you used your judgment?

A. Another place where -- this is all going to sound pretty silly -- but 3CG, the way that these commercial paper rates were quoted was based upon 360 days for a while. I guess it's because people didn't have computers, and they figured dividing by 360 was easier than 365. And then they changed the series to computing it on a 365-day basis. So instead of using the 360-day basis, we went back and readjusted those to a 365-day basis. We didn't find a good ten-year treasury bond series.

Q. This is in 4B?

A. This is from 4B. Sorry. And so what we did was, we took the five-year and the 20-year series from Ibbotson and apportioned them to come up with a ten, which would say essentially that there's a -- to the extent that the 20 year earns more than the five year, we're assuming a linear approximation to the ten year. You understand what I'm saying?

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Q. I do.

A. Okay. The triple A bond we actually used. You know, maybe you could get a series of triple A bonds. We couldn't find one, very simply, so we actually used a Salomon Brothers high-grade corporate bond index, which I believe is double A and triple A bonds.

Q. Is this for note 5B?

A. I'm sorry. Yes, it's 5B. And the opinion just says "the average-risk mutual fund."

Q. This is in 6B?

A. This is in 6B. They don't really talk about whether they mean a mutual fund that invests in stocks because there's bonds and there's everything else. But if you look at all the other types of investments that are there, it kind of seems like they must really be talking about a stock fund and not a bond fund. And then once you decide you're going to do a stock fund, which is the first judgment, which stock fund do you want to choose? You could use an international index. What are you going to use? We just used the S&P 500 because it seemed like something a US investor would pretty much -- but doesn't mean that you

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